# EXTERNAL AUDIT CIRCULAR No. 6

# CONNECTICUT DEPARTMENT OF TRANSPORTATION

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SUBJECT: Rental Costs of Facilities

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***This Circular presents interpretative guidance regarding facilities or equipment leased in a related-party transaction(common control) and includes examples for use in determining the allowability of such costs. Please refer to Chapter 8.23B and 11.4G (Example 11-8) of the 2010 edition of the AASHTO Uniform Audit & Accounting Guide for additional guidance.***

## I. ISSUE

During an indirect cost rate audit of a consultant, auditors may encounter costs for rental facilities or leased equipment that are included in the consultant's indirect costs. If common control exists between the consulting firm and the realty, holding company or equipment management company that owns the lease property, or if a sale-and-leaseback arrangement exists, then the allowable cost must be determined.

## II. ALLOWABILITY

A. Common Control

"Common control" shall be determined to exist if, in the relationship between a consulting firm and another company that is involved in real-property renting, leasing arrangements, or joint ventures, a principal or person with management responsibilities or significant influence in the consulting firm either—

1. Owns 50 percent or more of the other company,
2. Also is a principal or person with management responsibilities or significant influence in the other company,
3. Has a family member who he or she might exert influence or control over because of the family relationship and who is a principal or has management responsibilities or significant influence in the other company, or
4. Has a family member who might control or influence him or her because of the family relationship and who is a principal in or has management responsibilities or significant influence in the other company.

**Notwithstanding the foregoing criteria, common control also will be determined to exist when the interrelationship that exists between business entities makes it appear that the same persons control or have significant influence in those businesses. The emphasis here is on the concept of *effective control.***

If it is determined that common control exists, then charges in the nature of rent for real property are allowable only to the extent that they do not exceed the normal costs of ownership such as depreciation, taxes, insurance, facilities capital cost of money, and maintenance. It should be noted that, to be allowable, no portion of these costs may be duplicated in any other indirect cost accounts. Additionally, the costs in question must not violate applicable provisions of the Federal Acquisition Regulation (FAR). Finally, rental costs under a sale-and-leaseback arrangement are allowable only to the extent of the cost that would have been incurred by the consultant by retaining title to the leased property.

*Generally the property owner's tax return is the best source of information for costs associated with the property under common control. The most common sources include Form 1040 Schedule E for sole proprietors, Form 1065 for real estate partnerships, and form 1120 (C corporations) or 1120S (S corporations) for corporations formed to manage real estate.*

*Only allocable, allowable costs of ownership may be included in the cost-of-ownership computation.*

- *Mortgage payments – unallowable as these payments are comprised of principal amortization, which is a reduction to the liability account, and interest expense which is expressly unallowable per FAR 31.205-20. The annual depreciation expense in accordance with GAAP for the controlled property is allowable. Note that fully depreciated property might have no owner costs, as the value of the asset has been fully recovered through depreciation. Actual costs for fully depreciated property generally will be limited to operating costs paid by the owner which based upon the lease agreement may or may not included items such as real estate taxes, insurance, maintenance, repairs, utilities and property management fees. If the lessee pays these costs, they would not be included in the cost of ownership computation since they would have already been included in the indirect cost pool and thus would be a duplication of costs.*
- *The costs included in the computation must have been paid by the owner and not the consultant/lessee.*
- *If any portion of the business asset, including square footage of the building, is used for a purpose other than the firm's primary A/E operations, then the associated costs must be excluded from the cost of ownership computation. This includes the use of personal assets and/or the sublet of office space to another business entity.*

B. Idle Facilities

"Idle facilities" means completely unused facilities that exceed the consultant's current needs. Costs of idle facilities must be excluded from indirect costs unless (1) the costs are necessary to meet fluctuations in workload, or (2) the facilities, when acquired, were necessary but have become idle because of changes in requirements, production economies, reorganization, or other unforeseeable causes. Costs of idle facilities are allowable for a reasonable period, which generally may not exceed one year.

## III. EXAMPLES

**Example 6-1**. Allan and Bill, partners of *Consulting Firm X*, formed the *ABCD Real-Estate Partnership* with Chris and Daniel, unrelated third parties. Under the agreement, the partners each invested $30,000 of their personal funds to purchase a building, which was then leased to *Firm X* at a rate of $2,500 per month ($30,000 per year). *ABCD* will pay all insurance, legal fees, and taxes associated with the building, while *Firm X* will pay for utilities and maintenance and repairs.

Analysis: Allan and Bill hold 50 percent ownership in the building and were dominant in influencing the rental arrangement; accordingly, common control exists. Based on the computations shown in the Cost of Ownership tab to the Indirect Cost Rates Excel file, $25,950 is the allowable portion of the rent that may be included in *Firm X*'s indirect costs (thus, $4,050 of the total $30,000 proposed rent must be removed from indirect costs). Also note that since the insurance, legal fees, and taxes associated with the building were paid by the *ABCD Partnership*, these costs may not be included in *Firm X*'s indirect costs.

**Example 6-2**. During an audit of *Firm X*, it was revealed that 2,250 square feet of space in the leased building have remained idle for 2 years. As computed using the Cost of Ownership tab to the Indirect Cost Rates Excel file, $20,111 is the allowable portion of the rent that may be included in *Firm X*'s indirect costs ($9,889 of the total $30,000 proposed rent must be removed from indirect costs).

**Example 6-3**. A building owned by *Consulting Firm Y* was sold to a third party, and as part of the same transaction, *Firm Y* signed a long term lease to remain in possession of the building.

Analysis: This is a classic "sale-and-leaseback" transaction and is subject to the requirements of the FASB Statement No. 13 and various sections of the FAR. *Firm Y* will be required to perform analyses identical to those described in Examples 6-1 and 6-2 to determine allowable indirect costs.

## IV. COMPLIANCE REQUIREMENTS

In each of the above examples, the consulting firms must limit the lease expense claimed in indirect costs to the Cost of Ownership allowed by the FAR. Consultants can determine the Cost of Ownership by examining the Facilities Capital Cost of Money that applies to the leased property along with the property owners' accounting records or tax returns. If the consultant fails to make the required adjustment, then CTDOT auditors may make the necessary adjustments based on information made available by the consultant. If the consultant fails to make the required adjustment in any subsequent years, then CTDOT will disallow the full amount of the lease costs.

## V. REFERENCES

- FAR 31.205-36(b) (Rental Costs).
- FAR 31.205-11(i)(1) (Depreciation).
- FAR 31.205-17 (Idle Facilities and Idle Capacity Costs).
- DCAA Contract Audit Manual § 7-207 (Sale and Leaseback Transactions).
- FASB Statement No. 13 (Accounting for Leases).
- CTDOT External Audit Circular No. 1 (definitions, audit authority, and general guidance regarding the computation of indirect cost rates).
- AASHTO Uniform Audit & Accounting Guide [2010 Edition]